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Incentive Pay: Its Influence on the Wage Structure of Firms

Abstract:
Does incentive pay affect the wage structure of firms? Does the way individual productivity is measured matter for such effects? The aim of this paper is to analyze the wage structure of Dutch firms to answer these questions about the relation of wage structure and incentive pay. We use biennial data covering the period 1989-2001 from a panel of 3,000 Dutch establishments with detailed information about the wage structure of the establishment and the wage and personnel policy of the firm. It is also the first representative study about the wage structure of firms in the Netherlands.

The data distinguishes between firms with and without incentive pay. Incentive pay schemes are further split up in systems based on subjective evaluations and systems based on objective measurement. Over the time period covered in the data a substantial fraction of establishments introduce or cancel incentive pay scheme, allowing fixed effect estimates of the effect of incentive pay on several moments of the wage distribution.

In a cross-section, establishments with incentive pay are characterized by high mean wages, a high variance of the wages, while skewness is slightly lower than in other firms. The difference in mean wages is only observed in firms with incentive schemes based on subjective evaluation. Firms with incentive pay based on objective measures have on average the same mean pay as firms without incentive pay. The cross-sectional effects on variance and skewness are similar for both forms of incentive schemes.

Panel estimates of the effect of incentive pay on the variance of wages, using fixed establishment effects, are almost equal to the cross-sectional results, indicating that the incentive scheme fully accounts for these differences between firms. This holds for both schemes based on subjective evaluations and objective measures. In the panel we find no effect of incentive pay on the skewness. The panel estimates reveal an increase in mean pay when an incentive scheme is introduced based on a subjective evaluation while schemes based on objective measurement lower the mean wages.

We find therefore that while incentive schemes in both cases facilitate the distinction in pay between workers to a similar degree, subjective measurement seems to inflate wages while objective measures reduce average pay. This finding is consistent with the theory that subjective evaluation gives more bargaining power to the worker, through social pressure on the manager or by manipulating the evaluation, while objective measures allow direct alignment of productivity goals by the firm and wages paid to the workers.